

DRAFT

PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

**Telecommunications Division
Market Structure Branch**

**RESOLUTION T-16772
October 30, 2003**

R E S O L U T I O N

Resolution T-16772. SBC California (U-1001-C). Order accepting, subject to any corrections or adjustments as a result of future Commission Decisions, SBC California's Earnings Advice Letter Filing in Compliance with Decision 98-10-026.

By Advice Letter No. 23640 Filed on April 1, 2003.

Summary

This Resolution accepts SBC California's (SBC), annual earnings advice letter (AL) filing, subject to any corrections or adjustments that may be appropriate as a result of future Commission decisions or actions.

Since the sharing of excess earnings with ratepayers has been suspended by Decision (D.) 98-10-026, there is no impact on rates as a result of this filing at this time.

Background

New Regulatory Framework (NRF)

In D. 89-10-031, the Commission replaced cost-of-service regulation for SBC (formerly Pacific Bell) with the New Regulatory Framework (NRF). NRF was originally centered around a price cap indexing mechanism, with sharing of excess earnings above a benchmark rate of return level. It is commonly known as a "price cap" model. The price cap model updates revenues yearly for inflation and expected productivity improvements for the telecommunications industry based on the formula:

$$R(t) = R(t-1) \times (1 + I-X) + \text{or} - Z$$

In this formula, $R(t)$ is the rate to be set for the current year, $R(t-1)$ is the rate in the prior year, I is inflation as measured by the gross national product price index (GNP-PI), X is productivity, and Z is other exogenous cost changes that are beyond the control of utility management and are subject to the Commission's review and approval.

Under NRF, SBC is given an opportunity to earn a rate of return (ROR) above the traditional ROR used to establish a reasonable profit level to be included in the prices for utility services. The earnings sharing mechanism was adopted to provide a protection to ratepayers from an improperly functioning indexing mechanism. The sharing mechanism employs several ROR thresholds:

A market-based ROR (initially set at 11.50%) that reflects what a reasonable market driven ROR would be for a similarly situated utility with comparable risk.

A benchmark ROR (13%, 150 basis points higher than the market-based ROR) that is higher than the traditional ROR to provide a strong incentive to the utility to operate more efficiently.

A cap (ceiling) ROR (500 basis points higher than the market-based ROR) to protect ratepayers against the indexing mechanism that results in unreasonably high prices that result in excessive profit for the utility.

A floor ROR (325 basis points below the market-based rate of return) to provide a protection for shareholders in the event that indexing mechanism results in unreasonably low prices that result in insufficient earnings levels for the utility that are reasonably close to the market-based ROR.

Under this sharing mechanism, SBC would retain 100% of its earnings up to the benchmark ROR, would share with ratepayers 50% of its earnings between the benchmark and cap RORs, and would refund to ratepayers 100% of its earnings above the cap ROR. SBC was required to file an advice letter reporting its intrastate earnings for each year to determine whether sharable earnings exist. The filing was required to be made no later than April 1 of the following year.

Since the sharing mechanism was adopted in D.89-10-031, certain changes have been made to NRF for SBC and Verizon. D. 94-06-011, resulted from the first triennial review, and among other changes, reduced SBC's market base ROR to 10%, benchmark ROR to 11.50%, and allowed SBC to retain 70% of its earnings above the ceiling ROR with the remaining 30% returned to ratepayers.

The second triennial review resulted in another significant revision to NRF. In D.95-12-052, the Commission set the productivity factor in the price adjustment formula equal to

the inflation factor, essentially suspending the price indexing mechanism. The decision also froze the price caps on category I and II services, allowing only price changes that resulted from Z factor adjustments.

Decision 98-10-026, resulting from the third triennial NRF review, suspended earnings sharing effective January 1, 1999, eliminated depreciation reviews and made changes to the z factor mechanism by phasing out existing Z factor adjustments, eliminating new Z factor adjustments, and established a mechanism that allowed for the consideration of only a very limited set of exogenous costs. The decision continued the rate caps and floors. The Commission continued to require submission of an advice letter each April 1 for the purpose of monitoring ROR.

The Commission is currently conducting its fourth triennial NRF review of SBC. In the current NRF review (Phase II), the Commission is evaluating service quality and the results of an audit of SBC for the years 1997, 1998 and 1999. In addition, in the current NRF review (Phase III) the Commission is addressing the timing of the price cap advice letter filing, and is reviewing the criteria for revising service prices in the first part of Phase III (3A). The Commission intends to evaluate the NRF mechanisms in Phase III (3B). The results of Phase II and III are yet to be determined.

SBC'S ANNUAL EARNINGS FILING

Pursuant to D. 98-10-026, SBC filed its annual rate of return advice letter (AL), which is to be filed every April 1 for the purpose of reporting its actual ROR for the preceding year. The filing was made on a timely basis. SBC reported its annual ROR for the year 2002 as 9.73%. Other references reported in SBC's filing included the following rates of return:

Market-Based	10.00%
Benchmark	11.50%
Ceiling	15.00%
Floor	6.75%

Notice/Protests

SBC states that it mailed a copy of AL 23640 to competing and adjacent utilities and/or other utilities and interested parties as requested. AL No. 23640 was noticed in the Commission's Daily Calendar on April 9, 2003.

The Commission's Office of Ratepayer Advocates (ORA) filed a timely protest on April 29, 2003. ORA asserted that it could not determine if SBC's reported ROR was accurate because SBC provided no workpapers supporting the calculation of its ROR in its AL filing. ORA had requested supporting documents in Data Request (DR) No. AL23640_01, dated April 7, 2003. ORA further noted that the Commission is currently evaluating an audit of SBC for years 1997-1999 in the NRF review proceeding. ORA maintained that there may be findings in that proceeding that may impact the reported ROR for 2002. Also ORA indicated that future audits of SBC that might result from the Commission's decisions in this or subsequent NRF reviews could further impact SBC's 2002 ROR. ORA recommended that the Commission should accept SBC's AL 23640 only subject to restatement, due to the fact that the NRF reviews may impact SBC's ROR for year 2002.

SBC filed a timely response to ORA's protest on May 7, 2003. SBC stated it delivered workpapers supporting the reported ROR to ORA on April 24, 2003 and that ORA failed to point out any inaccuracy in SBC's AL. SBC believed its AL should be accepted unconditionally. However, as noted in the Commission's prior Resolution accepting SBC's 2001 ROR, the annual ROR filing is now simply informational in nature. SBC indicated that it would not object if the Commission accepts SBC's AL while also making it subject to any corrections or adjustments that may be appropriate as a result of future Commission decisions since the Commission accepted SBC's previous two annual ROR filings subject to the same conditions.

Discussion

We find no reason not to accept Pacific's reported ROR since the AL was filed on a timely basis and no deficiency in SBC's AL has been identified at this time. We are also mindful that the results of the current NRF audit and any future audits may impact SBC's 2002 ROR. Accepting SBC's AL subject to any corrections or adjustments resulting from future Commission decisions or actions is consistent with the Commission's treatment of SBC's previous two annual ROR filings. SBC states, in its response to ORA's protest, that it will not oppose the Commission accepting the ROR filing subject to any corrections.

Findings

- 1) Advice Letter No. 23640 was filed timely.
- 2) SBC reported its ROR for year 2002 was 9.73%.
- 3) Timely protest to AL 23640 was filed by ORA.
- 4) ORA requested workpapers supporting the calculation of SBC's ROR in Data Request No. AL23640_01 dated April 7, 2003.
- 5) SBC provided supporting workpapers to ORA via e-mail on April 23, 2003, and hard copies on April 24, 2003.

- 6) Earnings sharing is currently suspended pursuant to D. 98-10-026; there is no impact on rates as a result of this filing.
- 7) An audit of the Company's books and records for the period of 1997 through 1999 is included in the current (4th Triennial) NRF review.
- 8) The current NRF review includes the evaluation of its audit of SBC, which could have an effect on the year 2002 results of operations.
- 9) Future Commission decisions or orders could result in corrections or adjustments to the 2002 reported intrastate ROR.
- 10) The reference RORs are as follows:
 - Market-Based: 10%
 - Benchmark: 11.50% (+ 150 basis points)
 - Ceiling: 15% (+ 500 basis points)
 - Floor: 6.75% (- 325 basis points)

THEREFORE, IT IS ORDERED that:

1. SBC's Annual Earnings Advice Letter for the year 2002 shall be accepted subject to any corrections or adjustments that may be appropriate as a result of any future Commission decision or order.

This Resolution is effective today.

I hereby certify that this Resolution was adopted by the Public Utilities Commission at its regular meeting on October 30, 2003. The following Commissioners approved it:

WILLIAM AHERN
Executive Director